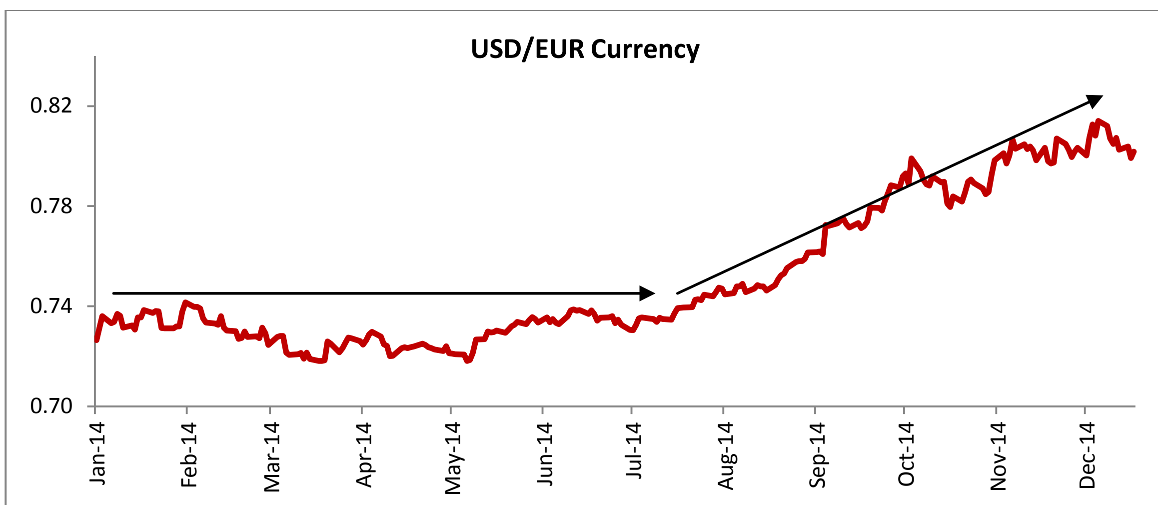
GLOBAL DEVELOPMENTS IN 2015: IMPACT ON VIETNAM ECONOMY

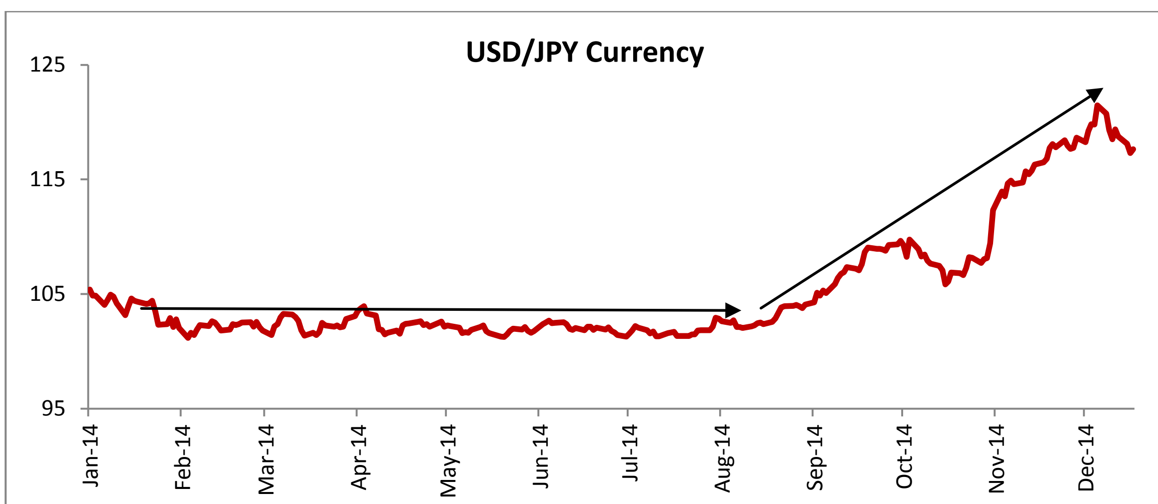
I. A STRONGER DOLLAR

The USD has begun a sustained rise against all major currencies, especially the Euro and the Yen. The appreciation started with the US Federal Reserve (Fed) giving indications of winding down its third quantitative easing (QE3) program, which was then terminated in late 2014.

Since 2008 the Fed has maintained its interest rate near zero. With the ending of QE3, a rise in US interest rates is only a matter of time. To calm a jittery stock market, Fed chairman Janet Yellen has repeatedly promised to keep interest low for a considerable period, probably until September 2015.



Date	USD/EUR	% USD change
1-Jan-14	0.726	
17-Dec-14	0.802	10.4%



Date	USD/JPY	% USD change
1-Jan-14	105.39	
17-Dec-14	117.14	11.1%

A stronger dollar entails some consequences.

US exports will become less competitive thus subtracting from its economic growth because net exports (X-M) is a component of GDP. The nascent recovery (which began gathering steam in recent months) may be weakened. US demand for exports from emerging markets (Vietnam included) may be negatively impacted.

With the dollar appreciating goes a relative decline in the currencies of emerging market economies especially those dependent on commodity exports and those for whom oil makes up a significant part of exports.

Nations that borrow in dollars now find themselves having to repay in a more expensive currency, thus having to bear a heavier debt burden which could lead to default. Venezuela and Nigeria are especially vulnerable. Venezuela is reported to be cutting government expenditure by 20 percent to contain its deficit and shore up confidence.

Similarly, business enterprises in many countries can find themselves exposed to high USD denominated debt, possibly leading to a spike in bankruptcies.

In order to defend their currencies and/or prevent capital outflows countries will be under pressures to raise interest rates. Global yields will trend upwards worsening the economic situations in Europe (with very anemic economic growth), China (with growth slipping below 7%) and Japan (already falling into recession).

Just last week, in a dramatic move the Russian central bank raised its key interest rate from 10.5% to 17%. The move symbolizes a surrender of economic growth for the sake of preventing a currency collapse. If sustained, the interest hike would slow down an economy already hobbled by western sanctions and record low oil prices.

The Indonesian rupiah has lost 20% versus the dollar so far this year and the slide is continuing due to significant capital outflows.

A rising dollar causes gold to lose its appeal as an investment channel. Gold price is falling to a multiyear low of $1,000 and is not expected to recover any time soon. The fall in gold prices comes as the dollar continues to strengthen against a basket of major currencies in expectation of stronger growth in the US economy. A stronger USD tends to dampen demand across commodities (such as gold and oil) which are traded in that currency.

Particular impact on Vietnam

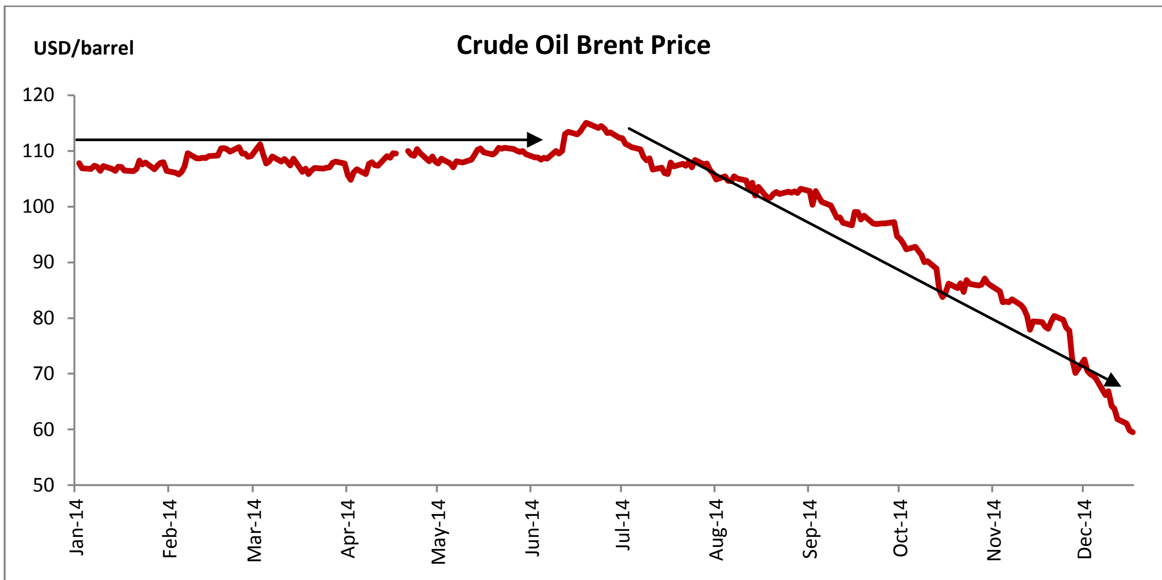
The SBV anticipates some pressures on the VND in 2015 due to a rising dollar but has capped its depreciation at 2% on the back of Vietnam's strong external positions (surplus on trade balance and overall BOP, record high FX reserves).

Contrary to other Asian neighbors (Indonesia, India) who receive significant inflows of short term capital which can change direction quickly and cause BOP stress, the VND is influenced more by

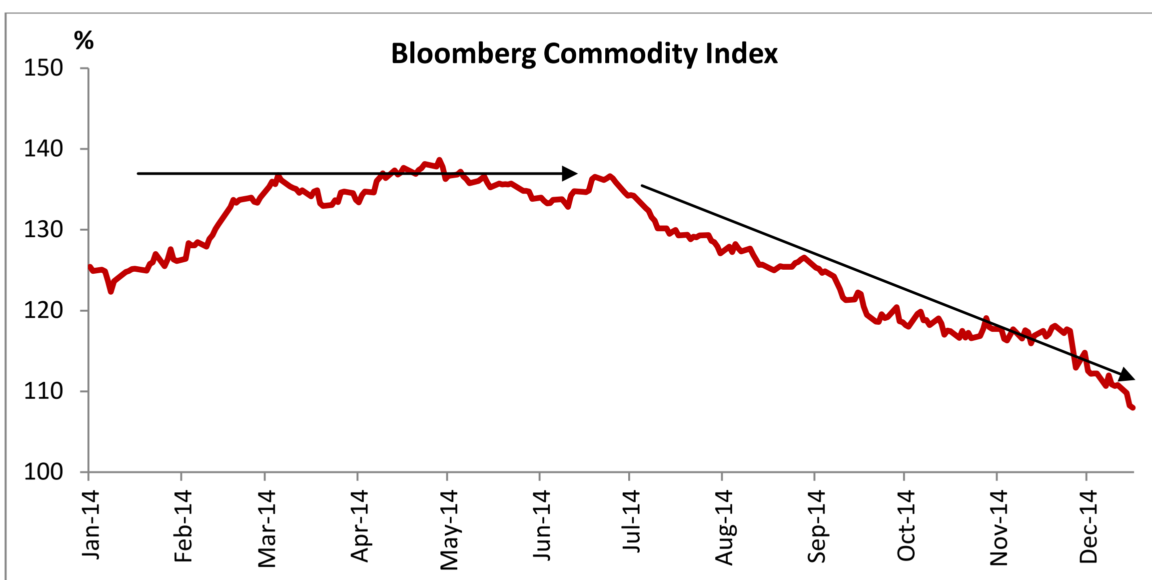
internal factors (low inflation, moderate and sustainable economic growth) which are presently supportive of a stable currency.

II. THE FALL IN OIL PRICES

Since June 2014 the price of high grade Brent crude oil has fallen almost 50% declining from $115 to $61 per barrel by mid December. This is the lowest since the 2009 global recession. The price decline has been deeper than expected in a normal cyclical correction and appears to be more than a temporary event. Many analysts project oil prices will stay below $60 per barrel in 2015 and could potentially fall as low as $40 per barrel.



Date	Oil price (USD/barrel)	% change
2-Jan-14	107.78	
19-Jun-14	115.06	6.8%
17-Dec-14	59.51	-48.3%



Date	Commodity Index	% change
2-Jan-14	125.40	
17-Dec-14	107.98	-13.9%

There are two explanations: not enough demand or too much supply. Supporting the weak demand argument, analysts can point to a stagnant economy in Europe, slower growth in China and recession in Japan. According to the IEA (International Energy Agency) world demand for oil grew only 1.5% in 2014.

But the bigger factor appears to be surging oil production which outpaced demand in 2014 and probably 2015 as well. In an effort to protect market shares, OPEC countries decided at a November meeting in Vienna not to reduce production levels, claiming that market forces should regulate such matters. Combined with the continued US and Canadian shale oil production, the world has more than enough to satisfy current demand.

How low can oil prices go? Some analysts expect a chaotic period in oil markets for the quarter ahead, saying that OPEC's decision not to cut production is extremely negative for oil prices in 2015. In the most pessimistic case, Brent oil price can go to $40 in 2015. Faced with this prospect, OPEC ministers still declared a willingness to let prices obey market forces rather than lowering production. Some analysts are quoted as saying that the US economy could see stronger than expected recovery next year, helping to push up oil prices. In fact, with oil falling below $50, many shale oil facilities will shut down to avoid losses and reducing US supply.

In principle, for all nations a fall in oil prices will benefit net oil importers while net oil exporters will be worse off. At the aggregate level such event is said to be a positive for the global economy. Christine Lagarde, IMF Director, was quoted as saying: "Assuming we have a 30% decline in oil prices, it's likely to be an additional 0.8% in economic growth for most advanced economies because all of them are importers of oil."

A report from Capital Economics attempts to measure the global lift from lower oil prices. A $10 fall in oil price would transfer the equivalent of 0.5% of world GDP from oil producers to oil consumers. This will have a knock-on effect on global consumption because consumers tend to have higher MPC (marginal propensity to consume) than producers. Assuming that consumers spend 50% of their savings from cheaper oil, a $10 fall in oil price will boost global demand for goods and services by 0.2% to 0.3%.

According to US analysts cheaper oil prices could increase purchasing power for American consumers in time for the holiday season. Cheaper gasoline acts like a tax cut by boosting disposable income which would flow through the economy in a significant way.

On the negative side, an oil price slide entails a few consequences.

- A more rapid appreciation of the dollar and a consequent weakening of emerging market currencies, in particular those dependent on oil exports. There has been a long and documented relationship between falling oil prices and a rising USD.
- Contributing to a general deflation in Europe and Japan. Despite massive liquidity injections from their central banks, their price levels are still falling almost towards zero. Oil deflation will add significantly to a recessionary drift in those areas.
- A decline in financial assets tied to oil can increase the tendency toward global financial instability. Oil deflation can lead to defaults and bankruptcies for various companies in the economy which in turn precipitate financial distress in the banks' lending to those businesses. The collapse of financial assets linked to oil could have a knock-on effect on other forms of assets, leading to instability in the economy.

Particular impact on Vietnam

The primary impact is on budget revenues from oil exports. On average, Vietnam exports 14 million tons of crude per year equivalent to 100 million barrels.

Since budget operations for 2014 are basically completed, the shortfall will be felt mostly in 2015. The government estimates that each $1 fall in oil price causes a revenue decline of VND 1,000 billion ($47.0 million). With oil price at $60 – $65 budget revenues would decline by VND 40,000 billion ($1.9 billion). For a worst case scenario with oil price at $40, the shortfall would be VND60,000 billion ($2.9 billion).

The government has recently raised the import tax on refined products to cushion the fiscal impact. The borrowing program in 2015 would also be adjusted to reflect a tighter budget. We take note that the contribution from crude oil export to state budgets is now about 10%, as compared to a more substantial 25% in previous years.

Given that Vietnam exports crude and imports refined products, value of the two flows is fairly balanced. The net impact on Vietnam's trade balance is therefore not significant and will not be a drain on its FX reserves, currently estimated at $38 billion, up from $35 billion at midyear.

Inflation will benefit from a reduction in oil price. Oil & gas is a product with widespread pricing ramifications into all major economic sectors (transports, manufacturing, industry, electricity) and influence their product prices to consumers. The low inflation this year is now all the more expected to persist into 2015 on the back of lower energy costs. With inflation in a low to moderate range, SBV can continue its monetary easing policy with further interest cuts, thereby helping both the bond and equity markets in their uptrend.

With regard to economic growth, initial estimates by government technical experts for 2015 indicate that:

- A 10% reduction in gasoline price implies: CPI lower by 0.55%, GDP higher by 0.51%
- A 20% reduction implies: CPI lower by 1.1%, GDP higher by 1.82%.
- A reduction of 30% or more can lead to losses for the national oil & gas sector and negatively impact GDP growth.

Retail sales – a proxy for private consumption – will get a boost because reduced energy prices will be equivalent to a tax cut, raising people's disposable income which they can spend on other consumer goods and services. Domestic demand (which has been weak this year) can become stronger and contribute more to economic growth in 2015. Therefore, we think the government target for a 6.0 - 6.2% GDP growth next year is quite achievable.

III. BOTTOM LINES

1. Rising dollar

- Some pressures on the VND but mitigated by strong external fundamentals (high FX reserves, surplus BOP). SBV has put a cap of 2% on VND depreciation in 2015.
- No need for raising interest rates to defend currency due to lack of hot money inflows.
- Amount of borrowings in dollar under control (and therefore not vulnerable to default risk) at country and business levels.
- Equity and fixed income markets not negatively impacted. Foreign investor confidence remains high (FDI commitments and disbursements on par with recent years. FII inflows circa $250 million versus $300 million last year).

2. Oil price deflation

- Minimal impact on trade balance: Vietnam exports crude and imports refined products in almost equal amounts, and therefore not leading to a drain on FX reserves.

- Some reductions in budget revenues but can be mitigated by more receipts from non oil businesses that will do well due to lower production costs.

- Inflation will stay low allowing for more rate cuts by central bank, stimulating more funding flows into equity and property in search of better returns. In such environment SBV can feel comfortable pursuing an accommodating monetary policy which is helpful for both equity and bond markets.

- Consumers gain ground due to effective income being worth more on the back of lower inflation. Domestic demand (which was weak in 2014) will improve due to higher purchasing power of consumers.

- In summary, with input prices falling and consumer demand picking up, we can look forward to better earnings from enterprises, which should drive the stock prices of listed companies higher.

Disclaimer by VinaCapital

Copyright 2014 VinaCapital (VNC). All rights reserved. This report has been prepared and is being issued by VNC or one of its affiliates for distribution in Viet Nam and overseas. The information herein is based on public sources believed to be reliable. With the exception of information about VNC, VNC makes no representation about the accuracy of such information. Opinions, estimates and projection expressed in this report represent the current views of the author at the date of publication only. They do not necessarily reflect the opinions of VNC and are subject to change without notice. VNC has no obligation to update, amend or in any way modify this report or otherwise notify a reader thereof in the event that any of the subject matter or opinion, projection or estimate contained within it changes or becomes inaccurate. The information herein was obtained from various sources which we believe to be reliable but we do not guarantee its accuracy or completeness.

Prices and availability of financial instruments are also subject to change without notice. This published research may be considered by VNC when buying or selling proprietary positions or positions held by funds under its management. VNC may trade for its own account as a result of short term trading suggestions from its analysts.

Neither the information nor any opinion expressed in this report constitutes an offer, or an invitation to make an offer, to buy or to sell any securities or any option, futures or other derivative instruments in any jurisdiction. Nor should it be construed as an advertisement for any financial instruments. Officers of VNC may have a financial interest in securities mentioned in this report or in related instruments. This research report is prepared for general circulation and for general information only. It does not have regard to the specific investment objectives, financial situation or particular needs of any person who may receive or read this report. Investors should note that the prices of securities fluctuate and may rise and fall. Past performance, if any, is no guide to the future.

The financial instruments discussed in this report may not be suitable for all investors. Investors must make their own financial decisions based on their independent financial advisors as they believe necessary and based on their particular financial situation and investment objectives. This report may not be copied, reproduced, published or redistributed by any person for any purpose without the express permission of VNC in writing. Please cite sources when quoting.